

DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year — \$75 Annually

Registered with the Securities Exchange Commission

May 5, 1971

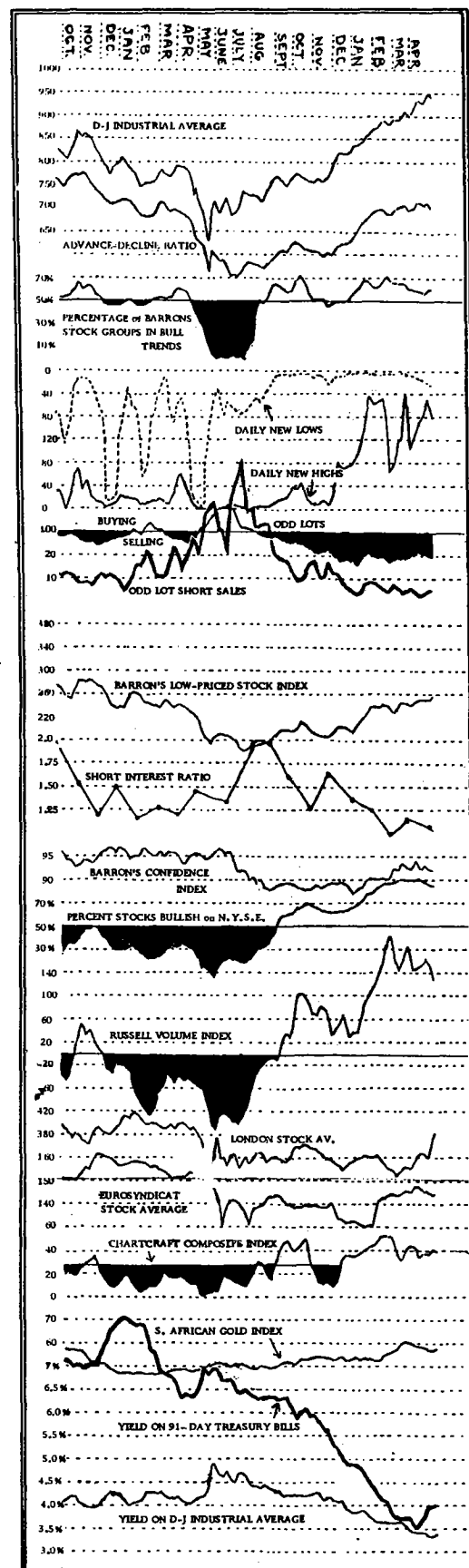
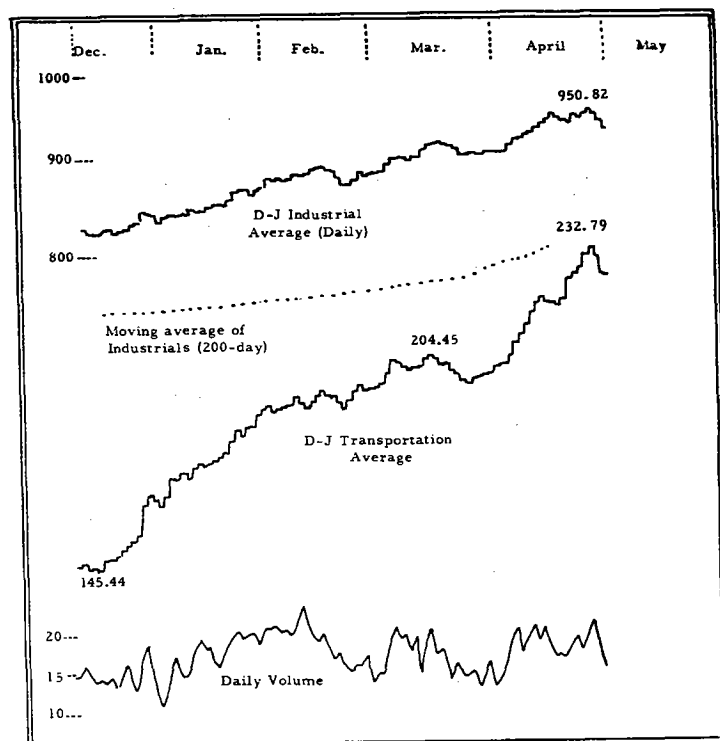
Letter 495

THE PICTURE: A private newsletter, Washington Watch says: "The fate of the American dollar hinges on a debate within the administration. In its simplest terms, while Secretary of Defense Laird and White House advisor Kissinger are arguing over Asian strategy, international financial circles are saying privately--the U.S. must pull out of Southeast Asia this year or devalue the dollar." As far as this writer knows, the U.S. has no intention of pulling out of Asia this year.

As you will see in a later section of this Letter, the U.S. now has total international monetary reserves of \$14.3 billion. Against these pitiful reserves, U.S. liabilities to European banks are estimated to be \$50 to as high as \$60 billion. As the dollar weakens, as the supports fold, as the "swaps" and forward hedges and manipulations fail one by one, there is going to be a mighty panic to get out of dollars.

Try to picture international creditors with \$50 billion in I.O.U.'s (dollar claims on gold) all waving those I.O.U.'s at the U.S., which, with its little pile of \$14.3 billion in reserves, is trying to stave off the inevitable crisis. Now, not all those creditors are going to sit quietly and wave their I.O.U.'s. A good many of them see the writing on the wall, and they are aware that not all the \$50 billion in dollar claims can get paid off with a U.S. gold pile which has just fallen under \$11 billion in total value. So the next thing to do is to get rid of dollars in the safest and most efficient possible way.

There are any number of ways of getting rid of dollars. You can buy art, you can buy land, you can buy a business, purchase oil leases, real estate, coins, on and on. But one of the quickest and easiest ways to get rid of dollars is an investment in stocks on the N.Y.S.E. And such an investment has advantages.



Page 2 It is liquid (you can get in and out fast), it is marginable, it often pays a dividend, and you have plenty of company (other stockholders) and plenty of comforting propaganda (mostly from U.S. political leaders).

So much for the rationale for buying stocks. My own opinion is that this market has embarked on its exotic, almost perpendicular climb (I am speaking of the Dow) because it has been the receipt of one of the biggest exits out of dollars in history. In the last Letter I published a chart of Barron's stock-bond ratio showing that the ratio had climbed to 1.23, its highest level of overvaluation (stocks vs. bonds) in history. The following week (week ending April 23) saw the ratio edge to a new historical peak of 1.24. This indicates a veritable route out of fixed debt (which is subject to the ravages of inflation) and into equities.

Now I'll make a statement which has proved true since stocks were first invented. In the final analysis, the only lasting bullish influence on equity prices is a steady advance in earnings. Nothing else will sustain a major movement. In my opinion, the greatest influence on stock prices since mid-1970 has been a flight from the dollar. Earnings have been a very secondary consideration, and in the majority of cases, stocks have risen on the basis of hopes, rising price/earnings ratios and investors' fears of being left behind in cash, bonds or fixed-dollar investments.

The most dangerous advance in stocks is one based on a flight out of currency. Sooner or later, such a rise in stock prices must have the confirmation of a major rise in earnings behind it -- or there will be trouble. I have included a chart showing the monthly Dow range, the Dow earnings (each dot represents earnings for the last 12 months), dividends on an annual rate, and the price/earnings ratio. Note that while earnings have declined, price/earnings ratios have advanced sharply to the latest reading (from Barron's of 18.6).

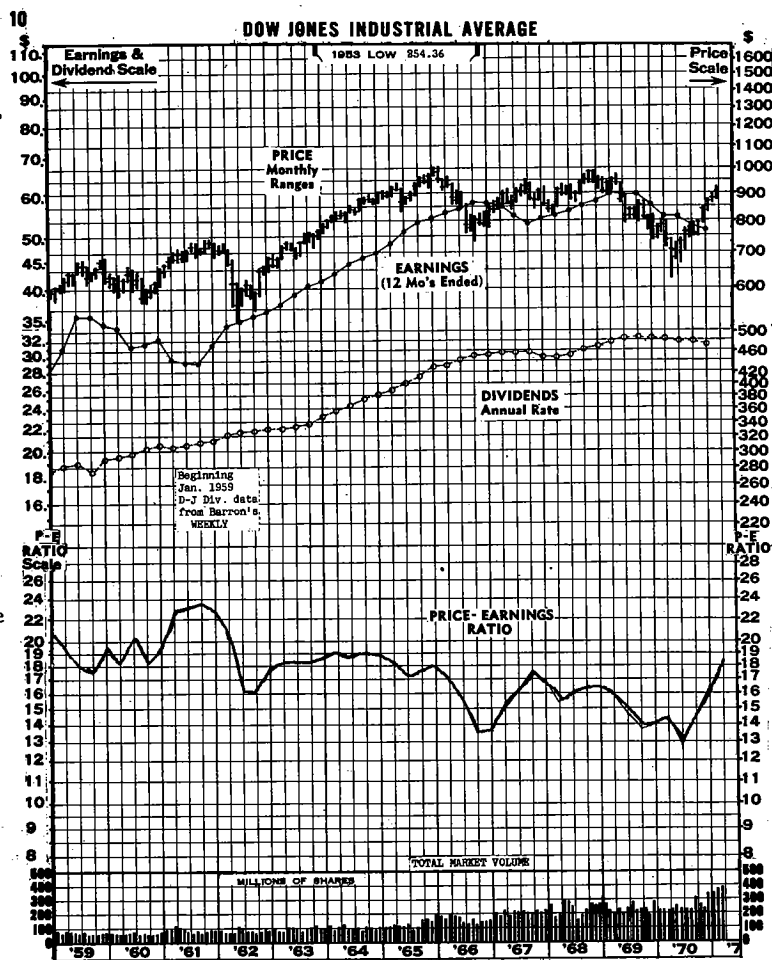
The conclusion is apparent. The rise so far has been based on a rise in earnings multiples. From a low of 12.8 times earnings in mid-1970, the multiple has risen almost 50% to the current 18.6. Now there is nothing unusual about this in a normal market. Stock multiples always go up ahead of the actual news of a rise in earnings. Nevertheless, a rise of 50% in price/earnings multiples in the face of the current very questionable chance of a big rise in earnings is quite extraordinary. The Dow, by rising from 631 to the mid-900's, has discounted a huge rise in earnings. OR, and this is what I suspect, the Dow has been subject to a massive buying panic based on a flight from the dollar. (Dow chart courtesy of Security Research, 208 Newbury St., Boston, Mass. 20116).

Last week I ran some computations, showing relative gains in the Dow and the advance-decline ratio from mid-1970 (when the upside action began) to the present. These comparisons suggested increasing strain on the part of the majority of issues (as reflected in the A-D ratio) as the Dow pushed higher.

For instance, during the first part of the recovery, from Dow 631 (May 26, 1970) to 783 (Oct. 7), the Dow gained 152 points. During that 152 point rise, the A-D ratio gained 4.56 points. In other words, each 33 points of gain in the Dow added one point to the A-D ratio.

The second move was more powerful in terms of the ability of the general market to keep up with the Dow. From the October 29, 1970 low of 752, the Dow rose to a February 16, 1971 high of 850. That was a gain of 138 Dow points. That rise added 8.66 points to the A-D Ratio. This means that it took only 16 points of gain on the Dow for each one point of gain in the A-D ratio. The A-D ratio rose twice as fast in terms of Dow points gained during this second movement.

The most recent rise started on February 27, 1971, at 868 on the Dow. The rise to 950 (April 29) added 82 points on the Dow. But during that period the A-D ratio managed to gain only 1.83 points. In other words, during the rise since February, it has taken a gain of 45 Dow points to produce a gain of 1 point in the A-D ratio. This amounts to "churning" on the part of the general market, in the face of the recent 82 point rise in the Dow.



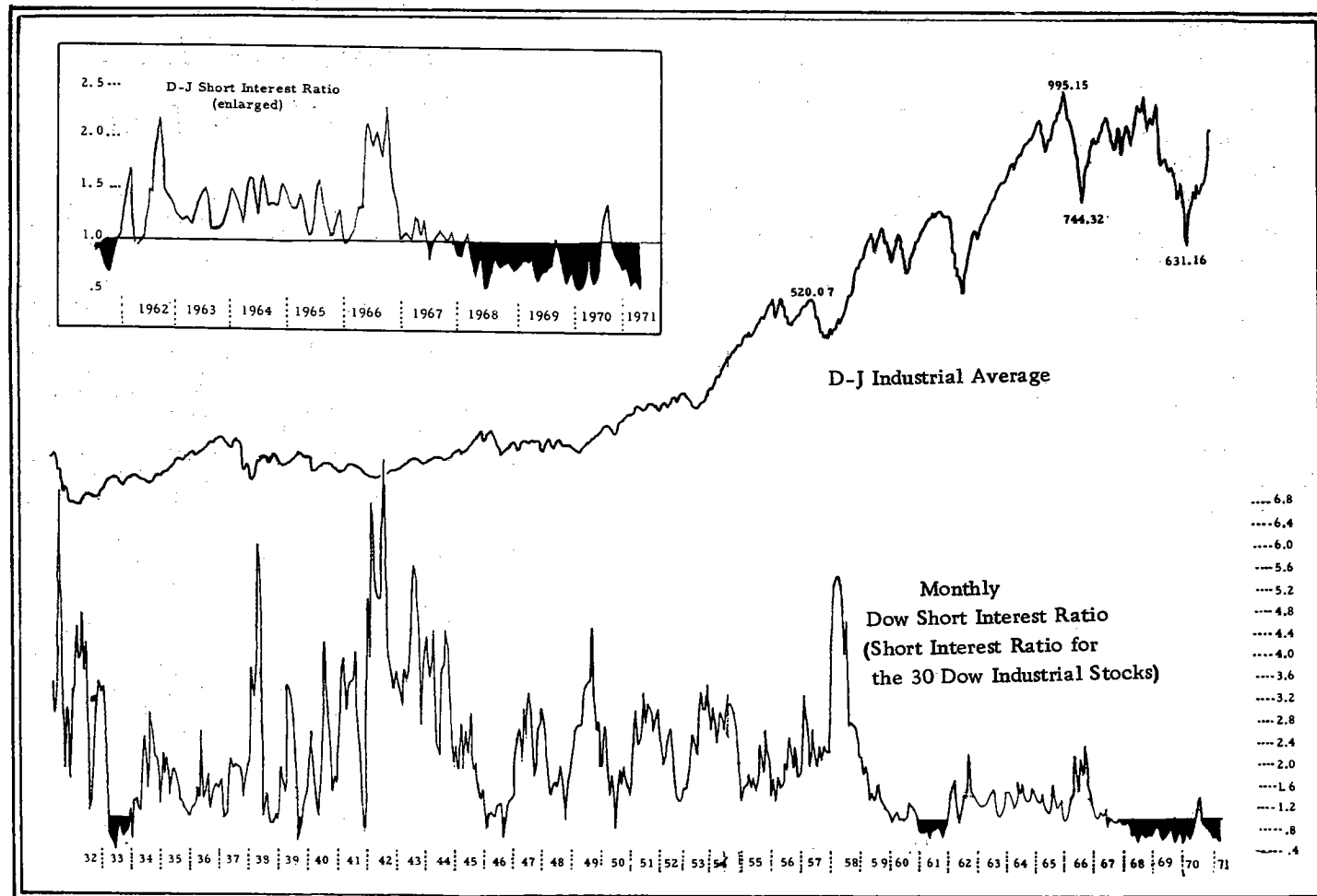
On April 29 the market turned down, following recovery highs of 950.82 on Industrials and 232.79 on the Transports. Incredibly, on the first day down from recovery highs in the Industrials and Transports, the Utility Average broke to a low for the year. This investment-grade Average, which has so often led the market, closed April 29 at 120.43, its lowest closing since December 28, 1970. This is indeed "strange action" in what has been widely proclaimed as "a new bull market".

It makes little sense to try to outguess this frenzied, inflation-inspired rally in a continuing primary bear market. On Friday (April 30), gold rose to \$39.70 an ounce, an 18-month high, and Germany (having absorbed over \$1 billion recently) abandoned its policy of supporting the dollar in the forward market. On the same day the Dow dropped 8 points. The decline continued with a vengeance on Monday (May 3), and I can only say that the bigger the rally and the more intense the speculation within a primary bear market, the more violent and brutal the ultimate descent. Make no mistake about it, the bear market is not over; the rally since mid-1970 simply coiled the bearish main spring tighter.

DOW SHORT INTEREST RATIO: This is the first time since Letter 475 (Oct. 7, 1970) that I have included the historical chart of the short interest ratio in the 30 Dow stocks together with the enlarged section covering the years since 1961.

As seen on the smaller insert, the Dow short interest is now in historically low territory, far below the critical 1.0 level. This descent into dangerous territory is partly a result of high volume in the 30 Dow stocks and partly a result of a decline of the total short interest in the 30 Dow stocks. The record is rather interesting. In August, 1970 (three months after the May bottom for the Dow) the total short interest in the Dow rose to slightly over 1 million shares, highest total since 1966. Since then there has been a steady drop in the total Dow shorts, down to last month's (April's) total of 637 thousand. This represents a 40% drop in shorts for the 30 Dow stocks, and that drop is mainly responsible for the bearish decline of the Dow short interest ratio.

I have gone back over all my figures and any way you look at it, the 1971 readings for the Dow short int. ratio are "screaming danger". For instance, the latest three months of 1971 produced ratio figures of .58 in February, .63 in March and .53 in April. This is a 3-month average of .58, the only lower 3-month average in history (going back to 1931) was .54, which included the first three months of 1970.



The latest figure of .53 which was registered in April is the second lowest monthly figure ever recorded by the Dow short interest ratio, the only lower being the exotic .37 of July, 1937. April's .53 was tied twice before, in February, 1970, and in July, 1968.

CONCLUSION: I would say that the Dow short interest ratio is now about as bearish as it can be, with it's .53 reading of April and the 3-month average of readings near its lowest point in history.

THE MOVING FINGER: I have been trying, in Letter after Letter, to show what is happening on the economic and monetary front. And all the while, the smokescreen of the "new bull market" is obscuring the seriousness of the situation. The fact is that monetary matters strike the average American as rather uninteresting subject. This is heightened by the problem that most Americans do not understand the monetary situation. Thus, it is the perfect vehicle for politicians, who do not understand it — but are abundantly willing to take advantage of it.

But the statistics keep piling up, and our international creditors know the score, and they know it well. Our creditors undoubtedly read the New York Times (Apr. 19), and they might have been aghast (that is, if anything shocks them now) to note that the U.S. payments deficit was \$5 billion for the first quarter, a new record (clip at right).

On April 24 our international creditors might have been disturbed to read in the Wall Street Journal that U.S. international reserves dropped from \$14.53 billion in February to \$14.34 billion in March, down from \$17.35 billion a year earlier (clip at lower right). This represents a 17% drop in reserves in a year!

I'd like to make this whole picture clear to subscribers, and perhaps Money & Credit Reports have the most servicable picture. In their recent report, they set up a simple asset-liability tabulation of U.S. figures as follows:

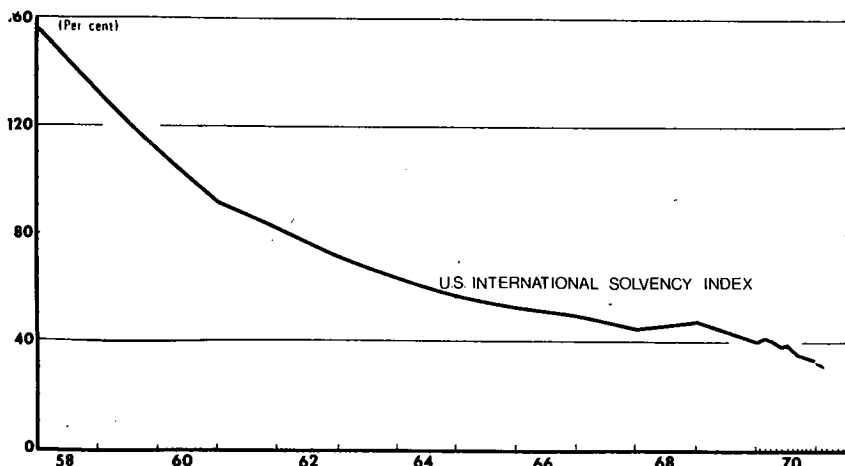
UNITED STATES (Feb. 29, 1971)
(In Billions of \$)

U.S. Reserve Assets:	
Gold Stock.....	11.0
Foreign Currencies.....	.3
Reserve in I.M.F.....	1.7
SDR's (Paper Gold).....	1.5
total.....	14.5

Current Liabilities:	
Total dollars held by foreigners ("Liquid Liabilities to Foreigners").....	Est. 46

U.S. INTERNATIONAL SOLVENCY INDEX = 32%

Now since this was published, the new figures have come out showing total U.S. reserves down to \$14.34 billion. Dividing this figure by the \$46 billion in current liabilities,



A Record Deficit for Payments Is Listed After Lag in Quarter

The United States balance of payments showed further deterioration during the first quarter to a record deficit on the official-settlements basis, the Morgan Guaranty Trust Company reported over the weekend.

The official-settlement deficit is estimated in the bank's publication, World Financial Markets, to have totaled about \$5-billion, a record for any quarter, compared with a \$3.2-billion deficit in the final 1970 quarter.

250,000.

U.S. Gold Stock Dropped in March To 23-Month Low

By a WALL STREET JOURNAL Staff Reporter

WASHINGTON—The U.S. gold stock fell \$76 million last month to its lowest level in almost two years, the Treasury reported.

At \$10.96 billion, the March gold stock was down from the \$11.04 billion of February and \$11.90 billion a year earlier. The March decline exceeded February's slim \$1 million drop and brought the gold stock to its lowest level since the \$10.94 billion of April 1969. It was the fifth consecutive monthly decrease and the sharpest since the \$406 million of last December.

The country's total international reserve assets fell to \$14.34 billion last month from \$14.53 billion in February and \$17.35 billion a year earlier.

Holdings of Special Drawing Rights, or "paper gold," fell to \$1.44 billion in March from \$1.47 billion a month before. The country's two annual allocations of SDRs have totaled \$1.58 billion, so the U.S. has had a net loss of more than \$140 million of paper gold since it was first issued Jan. 1, 1970.

Convertible foreign currencies fell to \$256 million in March from \$327 million a month earlier and \$1.95 billion a year before. The country's automatic ability to draw foreign currencies from the International Monetary Fund totaled \$1.68 billion last month, down from \$1.70 billion in February and \$2.58 billion a year earlier.

Dollars vs. Gold

Worsening U.S. Payments Deficit Held Threat to World's Monetary Stability

By LEONARD S. SILK

Special to The New York Times

BOLOGNA, Italy, April 20—The late great humorist, Robert Benchley, once did a piece explaining the world's monetary system. Mr. Benchley said that when you see finance ministers and central bankers flocking from capital to capital, running up and down stairs of foreign offices and international banks, and pausing to issue reassuring economic statements, you Analysis had better hide under the bed.

Last weekend, the central bankers flocked to Basel and ran up and down stairs. Reassuring statements are being issued. The economists who assembled in Bologna are now more convinced than ever that something is seriously wrong with the international monetary system.

The first thing that is wrong is the United States balance of payments. Last year, we ran an official reserves deficit of \$10-billion, the biggest in our history.

The Nixon Administration has exhibited what the French call chilled blood over this record deficit. And Mr. Nixon's economists have been saying that in 1971 the payments deficit would shrink to perhaps \$5-billion.

The bad news at the moment, however, is that the United States deficit in the first quarter of this year apparently totaled \$5-billion all by itself.

Yet this bad news did not result in panic or a massive run on the dollar. In effect, the United States Government has closed the gold window—not only to private speculators abroad but also to foreign governments, for all practical purposes.

To be sure, national governments still have the right to

demand gold for their dollars. American officials have never said they would refuse to give gold to foreign official dollar holders who demand it.

But this is peanuts—and the fact is that if the great nations collectively were to ask for gold in exchange for the dollars they are holding, we could not pay up. Our gold reserves cover only a small fraction of our dollar debts.

A few years ago, those who were longing for a return to the gold standard made us a proposition. They suggested that what we ought to do is devalue the dollar—that is, double the price of gold, pay off our dollar obligations, and still have enough gold left for table stakes in the ongoing international money game. But we would have to promise that from now on, we would settle our accounts in gold, not in dollars. No more I.O.U.'s.

The most important champion of this proposal was Prof. Jacques Rueff, economic adviser to General de Gaulle and Chancellor of the Institute of France. But in the last moments of this year's Bologna conference, Professor Rueff made a startling statement: the time, he said, is past when the world's monetary problem can be solved by devaluing the dollar in relation to gold.

"Now," said Mr. Rueff, "after the immense development of the Eurodollar market, this is no longer possible."

Just a few years ago—in 1967—the total dollar liabilities of the United States to European banks, governmental and private, totaled \$18-billion.

Dollar Liabilities Climbed

By the end of 1969, American dollar liabilities to European banks had climbed to \$46-billion—although, owing to the multiplying of dollars in the Eurodollar market, Euro-

pean banks claimed more dollar assets than we recognized as dollar liabilities.

Current estimates place our dollar liabilities to European banks above \$50-billion. They may be as high as \$60-billion.

But the United States has only \$15-billion in gold, even counting the gold that we have deposited to our credit at the International Monetary Fund.

A dollar devaluation would have to involve a fourfold multiplication of the gold price—from \$35 an ounce to \$140 an ounce—merely to enable us to wipe out our dollar debts to European central and private banks.

Such a massive rise in the price of gold would have a radical effect on the distribution of economic—and political—power among nations.

Realistically, Mr. Rueff recognized that the United States would not provide such an enormous reward for gold hoarders or speculators—or for such big gold-producing nations as South Africa and the Soviet Union.

Such a massive gold price increase would intensify inflationary pressures in many countries. Nations with big gold holdings—which would be augmented by converting their surplus dollars into gold—would have to sterilize a major part of their national gold reserves.

Mr. Rueff is far from putting the entire blame for what he calls an "immensely dangerous" situation on the United States.

"It was not the United States," he says, "who demanded that central banks issue more money against foreign exchange." In this sense, the Europeans have built their own inflations.

In the existing international monetary scheme, ongoing inflation can undermine both trade and capital movements among nations, as nations strive to protect their industries against disruptions stemming from monetary disorder.

A number of the world's most distinguished economists meeting in Bologna shared this anxiety. Few saw the existing dollar standard as more than a makeshift expedient.

The struggle over money is just one aspect of a deeper political and economic conflict among the nations of the west and Japan.

Yet there was little United States-baiting among the Europeans at the Bologna conference.

Appreciation has apparently grown over how close to an economic disaster the Capitalist nations have moved.

we get 31% for the new U.S. international solvency index.

To place the picture in perspective, I am including Money & Credit Report's chart of U.S. "solvency" going back to 1958. The deterioration here is breathtaking and obviously at the current rate the all out crisis cannot be far off.

On April 21 the New York Times ran the following story from Bologna, a story which was so interesting that I felt it was worth inserting here. To me the picture is comparable to a few dozen ants trying to do something with a basketball. The ants are too small, and the basketball is too big. The ants might let the air out of the ball, they might even get it to roll

Page 6 in a different direction. The ball is too big to handle and too big to get rid of. In case you didn't guess, the ants are the international bankers and economists (with apologies to Mr. Rueff, for whom I have the highest respect), and the ball is the monetary system.

ALMOST EVERY DAY my mail brings me two or three letters or articles from subscribers or others who are upset about the trend of events. It is not gains or losses in the market which disturbs them, however, it is a vision of things to come. I have noticed a number of similarities about these people and I list a few:

- (1) Many of them are older citizens, they have seen a lot, and have had much time to think.
- (2) Many of them are conservative about their financial affairs, but surprisingly liberal regarding their social values.
- (3) They tend to see new and important values in the current ideas and movements of the young.
- (4) They believe that the old order is rotting, and that something new and better will emerge (once the old order gives way).

Following is a letter just received from a subscriber in Louisville, Ohio. When I lived in N.Y.C. a decade ago, I used to think New York had a corner on brains, and that everything more than 50 miles from Gotham was covered with hay seeds and swamp grass. I've changed my mind since then. Brains, like everything else, is where you find them.

Dear Mr. Russell:

I am 64 - a lifelong student of the market and I enjoyed your recent letter on "Winds of Change". Yes, I believe you are correct in your idea of the future of the Dow. These turbulent movements always contain a "message" I believe. If you can read the big message it may help you survive financially. Here's how I read the history: (nutshell)

I regarded the depression as a grinding out of feudal capitalism - it simply lacked vision and was too provincial to meet a modernizing world. Wendell Wilkie glimpsed it with his vision of "one world". Others also.

It seems there are occasional historical moments when history takes a slight deflection and the world is never the same. Such was Agincourt or Hastings as it foretold the death of kings. Very likely we have seen another with the rising of the first silver ball (space probe, ed.)

The market had not yet finished its slaughter of feudalism when a historical aberration (Hitler) placed it on a war basis - where it has remained. The student should keep this fact in mind. Neither Roosevelt nor any of his followers saved the Dow. Perpetual war saved it. But mankind is a survivor. Every genetic chain is but a computer print-out of survival. Now war can be glory - or glamor - or need - or expedience. It is often those, but it is anti-survival too. The modern brutalized, genocidal war is anti-human and anti-survival and is thus stirring deep survival motivation. Now to the current Dow message:

I told my broker friend during the '69 crash that the Dow was shouting in loud, clear voice, "Have done with war, you fools". War can no longer be the chief arbiter of mankind's destiny. It threatens survival. If this is what the Dow was saying, it is the most startling message since Christ. Every day I become more convinced that this is the message.

It is not necessary that the Dow, or the people, or the politicians see it. So far it is only sensed! The children have sensed it. What a shabby monstrous world we show them. But a child will lead us. I would no more expect the kids to support the inhuman values we offer than I would have expected Walter Reuther to have supported the world of Elbert H. Gary.

Yes, winds of change, Mr. Russell. The future of the Dow is currently very bleak. It will grind out everything that stands in its path. We will walk a knife edge for years. We have the push buttons and the nuts to push them aplenty. The tendency is, and will be, strong to push them. But the Dow price will be pretty low in that context too. They will have to do some survival thinking also. I believe they will have to push the big button very soon - or the Dow is going to grind them all out.

The Calley out-pouring clinched my belief. More than a protest of his sentence, it was a blind rage against politicians and the system which caused such things. Few see it yet. Current leaders are twisting and turning to maintain old order. It is impossible - they will get ground out.

Regards,

Paul P.